

DERIVATIVES AND STRUCTURED PRODUCTS | June 8, 2016

## CFTC Adopts Final Rules Regarding the Cross-Border Application of Its Swap Margin Requirements

On May 24, 2016, the US Commodity Futures Trading Commission (“CFTC”) adopted a final rule defining the cross border application of its margin requirements for uncleared swaps. The final rule covers all swap dealers and major swap participants subject to the CFTC’s margin rules—that is, those registered with the CFTC but not subject to the margin rules of the US bank regulators.<sup>1</sup>

Such entities are referred to as covered swap entities (“CSEs”).<sup>2</sup> The CFTC rule generally requires CSEs engaging in uncleared cross-border swaps to comply with the CFTC’s margin requirements, with certain exceptions depending on the location of the CSE and the type of counterparty with which the CSE transacts:

- US CSEs must comply with the CFTC margin rules when transacting with a US counterparty or a non-US counterparty whose swap obligations are guaranteed by a US person.
- US CSEs must comply with the CFTC margin rules when transacting with certain other non-US counterparties, but may be eligible for substituted compliance with respect to certain requirements.
- Non-US CSEs must generally comply with the CFTC margin rules when transacting with a US counterparty, but may be eligible for substituted compliance with respect to certain requirements.
- Non-US CSEs must generally comply with CFTC margin rules when transacting with a non-US counterparty whose swap obligations are guaranteed by a US person, but may be eligible for substituted compliance with respect to certain requirements.
- Non-US CSEs whose swap obligations are not guaranteed by a US person generally need not comply with the CFTC margin rules when transacting with a non-US counterparty whose swap obligations are not guaranteed by a US person.

These rules are generally similar to the cross-border approach adopted by the US banking regulators (the “Prudential Regulators”)<sup>3</sup> for swap dealers and major swap participants under their jurisdiction.<sup>4</sup> As discussed further below, however, the Prudential Regulators’ approach may allow more expansive application of substituted compliance for Non-US CSEs that are not guaranteed by US persons than under the CFTC cross-border rule.

### Background

Requiring initial and variation margin for uncleared swaps is a key aspect of derivatives regulatory reform both in the United States under the Dodd-Frank Act and in other jurisdictions. In furtherance of this goal, on December 16, 2015, the CFTC adopted final rules imposing margin requirements for uncleared swaps entered into by CSEs.<sup>5</sup> At that time, the CFTC deferred addressing the application of its rules on a cross-border basis until the current

rulemaking.<sup>6</sup> The final rules on cross-border application of margin requirements will take effect in accordance with the same compliance schedule for the margin requirements themselves set forth in the Final Margin Rules. The timetable for implementation is set out in Appendix B.

## Key Categories

The cross-border rules classify CSEs and their counterparties based on regulated status and certain connections to the US.

Under the rules, a “US person” is (i) a natural person who is a resident of the United States; (ii) an estate of a decedent who was a resident of the United States at the time of death; (iii) a corporation, partnership, limited liability company, business or other trust, association, joint-stock company, fund or any form of entity similar to any of the foregoing other than an entity described in (iv) or (v) below (a “legal entity”), in each case that is organized or incorporated under the laws of the United States or that has its principal place of business in the United States, including any branch of such legal entity; (iv) a pension plan for the employees, officers or principals of a legal entity described in (iii), unless the pension plan is primarily for foreign employees of such entity; (v) a trust governed by the laws of a state or other jurisdiction in the United States, if a court within the United States is able to exercise primary supervision over the administration of the trust; (vi) a legal entity (other than a limited liability company, limited liability partnership or similar entity where all of the owners of the entity have limited liability) that is owned by one or more persons described in (i) through (v) and for which such person(s) bears unlimited responsibility for the obligations and liabilities of the legal entity, including any branch of the legal entity; or (vii) an individual account or joint account (discretionary or not) where the beneficial owner (or one of the beneficial owners in the case of a joint account) is a person described in (i) through (vi). Notably, the definition does not include one of the prongs of the US person definition under the CFTC’s general Cross-Border Guidance: collective investment vehicles that are organized and have their principal places of business outside the United States, but are majority owned by US persons.<sup>7</sup>

As used herein, a “US CSE” is a CSE that is a US person, and a “Non-US CSE” is a CSE that is not a US person. The CFTC definition of a Non-US CSE includes a US branch of a non-US CSE and a Foreign Consolidated Subsidiary. The distinction is relevant in that US branches of non-US CSEs and Foreign Consolidated Subsidiaries are not treated as US persons but are treated differently from other Non-US CSEs in some instances under the cross-border rules.

A Foreign Consolidated Subsidiary (“FCS”) is a non-US CSE in which a US person ultimate parent entity has a controlling financial interest, such that the FCS’s operating results, financial position and statement of cash flows is consolidated in the US ultimate parent entity’s financial statements, as determined in accordance with US GAAP.

The cross-border rules also distinguish among counterparties based on whether there is a guarantee by a US person of the relevant swap obligations of a party to the uncleared swap. A guarantee for this purpose is an arrangement pursuant to which one party to an uncleared swap has rights of recourse against a guarantor, with respect to its counterparty’s obligations under the uncleared swap.<sup>8</sup>

## Application of the Margin Requirements

The cross-border rules apply the CFTC margin requirements (and potential exceptions and exemptions therefrom) based on the type of CSE and counterparty in question. Appendix A is a table provided by the CFTC demonstrating the application of the cross-border rules.

### *Scenario 1:*

#### *US CSEs*

#### *Non-US CSEs whose obligations under relevant swap are guaranteed by a US person*

- US CSEs and non-US CSEs<sup>9</sup> whose obligations under the swap are guaranteed by a US person must comply with the Final Margin Rules (for both posting and collecting margin) when transacting with any counterparty (whether or not a US person).
- The final rules provide a limited exception if the counterparty is a non-US person (including a non-US CSE FCS, or a US branch of a non-US CSE) whose swap obligations are not guaranteed by a US person. In that case, if the CFTC makes a comparability determination with respect to the relevant margin regime of a non-US jurisdiction applicable to the counterparty, the CSE may rely on substituted compliance with the foreign margin rules in respect of only the CSE's obligation to post initial margin.<sup>10</sup> The CSE must still follow the CFTC margin rules regarding collection of initial margin and posting and collection of variation margin.

### *Scenario 2*

#### *Foreign Consolidated Subsidiaries or US branch of a non-US CSE whose obligations under relevant swap are not guaranteed by US person*

An FCS or US branch of a non-US CSE whose swap obligations are not guaranteed by a US person is generally subject to the CFTC Final Margin Rules when transacting with any counterparty (whether or not a US person). In certain cases, however, the FCS or US branch may rely on substituted compliance with a foreign margin regime that has been the subject of a comparability determination by the CFTC:

- If the counterparty is a US CSE or a Non-US CSE whose swap obligations are guaranteed by a US person, then the FCS or US branch may rely on substituted compliance with respect to its obligation to collect initial margin only. The FCS or US branch would still be required to post initial margin and post and collect variation margin in accordance with the CFTC Final Margin Rules.
- For other counterparties, the FCS or US branch may rely on substituted compliance with the foreign margin regime for both collecting and posting initial and variation margin. The greater leeway for complying with foreign rules in transacting with non CSE entities reflects the lower systemic risk inherent in dealing with non CSEs.

### *Scenario 3*

#### *Non-US CSEs (excluding US branches of non-US CSEs and Foreign Consolidated Subsidiaries) whose obligations under the relevant swap are not guaranteed by a US person*

For other Non-US CSEs that are not guaranteed by a US person, the CFTC Final Margin Rules will only apply in certain situations:

- The Non-US CSE will generally be subject to the CFTC Final Margin Rules when transacting with a counterparty that is a US CSE or a Non-US CSE guaranteed by a US person.
- However, the Non-US CSE may satisfy its requirement to collect initial margin from the counterparty by substituted compliance with a foreign margin model for which the CFTC has made a comparability determination. The Non-US CSE would still be required to post initial margin and post and collect variation margin in accordance with the CFTC Final Margin Rules.
- Conversely, the CFTC Final Margin Rules will generally not apply when such a non-US CSE transacts with a counterparty that is not a US person, unless the counterparty is a US branch of a Non-US CSE, a Foreign Consolidated Subsidiary or is guaranteed by a US person.<sup>11</sup>
- In addition, if the counterparty is not a US CSE or a Non-US CSE guaranteed by a US person and the CFTC margin rules would otherwise apply, substituted compliance may be available if the CFTC has made a comparability determination with respect to the foreign margin regime applicable to the Non-US CSE. This exemption may apply to transactions with counterparties that are US persons other than CSEs as well as Foreign Consolidated Subsidiaries that are not guaranteed by US persons.

### Special Provisions

In adopting the final cross-border rules, the CFTC recognized that the legal and operational infrastructure of some jurisdictions makes it impractical to comply with the CFTC's custodial requirements.<sup>12</sup> Without an exemption, CSEs might be restricted from transacting with counterparties in these jurisdictions. The rule allows FCSs and foreign branches of US CSEs to transact with non-US, non-CSE counterparties whose swap obligations are not guaranteed by a US person, without complying with either (i) the requirement to post initial margin or (ii) the custodial segregation requirements; provided the transactions subject to this exemption do not exceed 5% of the total outstanding notional value for all uncleared swaps of the CSE in the same broad risk category (credit, equity, foreign exchange/interest rate and commodities). This 5% cap applies to each of these risk categories separately. This exception is only applicable to the extent there is no form of eligible initial margin collateral that can be posted in compliance with the custodial requirements under the Final Margin Rules. The CSE would still be required to collect initial margin in the form of cash and post and collect variation margin in the form of cash in these jurisdictions consistent with the Final Margin Rules. Further, the CSE must have policies in place to ensure compliance with these special rules and keep records documenting compliance with these special rules.

### Substituted Compliance

Any CSE or foreign regulatory authority can request that the CFTC determine the comparability of a foreign jurisdiction's margin rules. The CFTC requires extensive documentation detailing the foreign jurisdiction's margin requirements and how the requirements address specific elements prescribed in the rule. The CFTC also requires a description of the differences between the foreign jurisdiction's requirements and the CFTC's requirements, the foreign jurisdiction's authority to supervise and enforce its rules, as well as any other information the CFTC requests. The CFTC can determine that certain elements of the foreign requirements are comparable, but others are not. In light of the first margin compliance deadline of September 1, 2016, the CFTC encouraged persons requesting a comparability determination to submit their requests promptly.

### **Comparison with Prudential Regulators Final Rules**

The CFTC's cross-border rules are generally similar to the cross-border approach in the Prudential Regulators' Final Margin Rules. Both rules determine applicability based on the type of CSE and counterparty in question and contemplate reliance on substituted compliance in certain scenarios. However, the CFTC's approach may allow more limited reliance on substituted compliance than under the Prudential Regulators' Final Margin Rules. Specifically, subject to a comparability determination by the Prudential Regulators, the Prudential Regulators' approach generally permits substituted compliance with respect to all margin posting and collection requirements for non-US bank CSEs, FCSs<sup>13</sup> and US branches of non-US bank CSEs whose swap obligations are not guaranteed by a US person regardless of whether the counterparty is a US person. In contrast, full substituted compliance may be available under the CFTC's Final Margin Rules only when non-US bank CSEs, FCSs and US branches of non-US bank CSEs whose swap obligations are not guaranteed by a US person transact with a counterparty who is a non-US person that is not a CSE or a non-US CSE whose swap obligations are not guaranteed by a US person. Limited substituted compliance, however, may be available for other counterparties as further described above.

### **Implementation Issues**

Implementation of the cross-border rules is likely to prove complex. How a particular transaction is treated depends on how both the CSE and its counterparty are classified in terms of location and regulatory status, among other factors. Furthermore, based on the categorization of such entities, certain transactions may be subject to two different margin regimes, one for each side of the transaction. How well such an approach works in practice may depend on whether other jurisdictions take a similar approach. Further, there is considerable uncertainty regarding whether substituted compliance relief will be provided, and there is no assurance that any such relief will be provided by September 1, 2016. Given this uncertainty, it may be prudent for market participants that may be subject to the CFTC Final Margin Rules beginning on that date (see the implementation schedule in Appendix B) to prepare for compliance assuming no substituted compliance will be available, at least initially.

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This memorandum is intended only as a general discussion of these issues. It should not be regarded as legal advice. We would be pleased to provide additional details or advice about specific situations if desired.

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Appendix A

CSE	Counterparty	Applicable Margin Requirements
<p><b>US CSE</b></p> <p>or</p> <p><b>Non-US CSE (including US branch of a non-US CSE or FCS) whose obligations under the relevant swap are guaranteed by a US person</b></p>	<ul style="list-style-type: none"> <li>US person (including US CSE)</li> <li>Non-US person (including non-US CSE, FCS and US branch of a non-US CSE) whose obligations under the relevant swap are guaranteed by a US person</li> </ul>	<p>CFTC (All)</p>
	<ul style="list-style-type: none"> <li>Non-US person (including non-US CSE, FCS and US branch of a non-US CSE) whose obligations under the relevant swap are <i>not</i> guaranteed by a US person</li> </ul>	<p>CFTC (Initial Margin collected by CSE in column 1)</p>
		<p>Substituted Compliance (Initial Margin posted by CSE in column 1)</p>
		<p>CFTC (Variation Margin)</p>

CSE	Counterparty	Applicable Margin Requirements
<p><b>FCS whose obligations under the relevant swap are <i>not</i> guaranteed by a US person</b></p> <p><b>or</b></p> <p><b>US branch of a non-US CSE whose obligations under the relevant swap are <i>not</i> guaranteed by a US person</b></p>	<ul style="list-style-type: none"> <li>• US CSE</li> <li>• Non-US CSE (including US branch of a non-US CSE and FCS) whose obligations under the relevant swap <i>are</i> guaranteed by a US person</li> </ul>	CFTC (Initial Margin posted by CSE in column 1)
		Substituted Compliance (Initial Margin collected by CSE in column 1)
		CFTC (Variation Margin)
	<ul style="list-style-type: none"> <li>• US person (except as noted above for a CSE)</li> <li>• Non-US person whose obligations under the swap <i>are</i> guaranteed by a US person (except a non-US CSE, US branch of a non-US CSE and FCS whose obligations are guaranteed, as noted above)</li> <li>• Non-US person (including non-US CSE, US branch of a non-US CSE and a FCS) whose obligations under the relevant swap are <i>not</i> guaranteed by a US person</li> </ul>	Substituted Compliance (All)



CSE	Counterparty	Applicable Margin Requirements
<p><b>Non-US CSE (that is not an FCS or a US branch of a non-US CSE) whose obligations under the relevant swap are <i>not</i> guaranteed by a US person</b></p>	<ul style="list-style-type: none"> <li>• US CSE</li> <li>• Non-US CSE (including US branch of a non-US CSE and FCS) whose obligations under the swap <i>are</i> guaranteed by a US person</li> </ul>	CFTC (Initial Margin posted by CSE in column 1)
		Substituted Compliance (Initial Margin collected by CSE in column 1)
		CFTC (Variation Margin)
	<ul style="list-style-type: none"> <li>• US person (except as noted above for a CSE)</li> <li>• Non-US person whose obligations under the swap <i>are</i> guaranteed by a US person (except a non-US CSE whose obligations are guaranteed as noted above)</li> <li>• US branch of a non-US CSE or FCS, in each case whose obligations under the relevant swap are <i>not</i> guaranteed by a US person</li> </ul>	Substituted Compliance (All)
	<ul style="list-style-type: none"> <li>• Non-US person (including a non-US CSE, but not an FCS or a US branch of a non-US CSE) whose obligations under the relevant swap are <i>not</i> guaranteed by a US person</li> </ul>	Excluded (except in connection with certain inter-affiliate swaps)

**Note:** Substituted compliance requires a comparability determination by the CFTC for the relevant requirement. Absent such a determination, the CFTC margin rules apply.

**Appendix B**

**Implementation of Initial Margin Requirements**

Compliance Date	Initial Margin Requirements
September 1, 2016	Initial margin required where both the CSE combined with all its affiliates and its counterparty combined with all its affiliates have an average daily aggregate notional amount of covered swaps for March, April and May of 2016 that exceeds \$3 trillion.
September 1, 2017	Initial margin required where both the CSE combined with all its affiliates and its counterparty combined with all its affiliates have an average daily aggregate notional amount of covered swaps for March, April and May of 2017 that exceeds \$2.25 trillion.
September 1, 2018	Initial margin required where both the CSE combined with all its affiliates and its counterparty combined with all its affiliates have an average daily aggregate notional amount of covered swaps for March, April and May of 2018 that exceeds \$1.5 trillion.
September 1, 2019	Initial margin required where both the CSE combined with all its affiliates and its counterparty combined with all its affiliates have an average daily aggregate notional amount of covered swaps for March, April and May of 2019 that exceeds \$0.75 trillion.
September 1, 2020	Initial margin required for any other CSE with respect to covered swaps with any other covered counterparty.

**Implementation of Variation Margin Requirements**

Compliance Date	Variation Margin Requirements
September 1, 2016	Variation margin required where both the CSE combined with all its affiliates and its counterparty combined with all its affiliates have an average daily aggregate notional amount of covered swaps for March, April and May of 2016 that exceeds \$3 trillion.
March 1, 2017	Variation margin required for any other CSE with respect to covered swaps with any other counterparty that is a swap entity or financial end user.

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- <sup>1</sup> 17 C.F.R. § 23.160 (2016) available at <http://www.cftc.gov/idc/groups/public/@lrfederalregister/documents/file/2016-12612a.pdf>.
- <sup>2</sup> Specifically, a CSE is a swap dealer and major swap participant registered with the CFTC for which there is no Prudential Regulator (as defined below).
- <sup>3</sup> The Prudential Regulators are as follows: Office of the Comptroller of the Currency, Treasury; Board of Governors of the Federal Reserve System; Federal Deposit Insurance Corporation; Farm Credit Administration; and Federal Housing Finance Agency.
- <sup>4</sup> See Margin and Capital Requirements for Covered Swap Entities, 80 Fed. Reg. 229 (Nov. 30, 2015) (to be codified at 12 C.F.R. pts. 45, 237, 349, 624, 1221); 12 C.F.R. pts. 45, 237, 349, 624, 1221 (2016). (“Prudential Regulators’ Final Margin Rule”).
- <sup>5</sup> Margin Requirements for Uncleared Swaps for Swap Dealers and Major Swap Participants, 81 Fed. Reg. 3 (Jan. 6, 2016) (to be codified at 17 C.F.R. pts. 23, 140); 17 C.F.R. pts. 23, 140 (2016). (the “Final Margin Rules”).
- <sup>6</sup> The CFTC had previously repropose rules regarding the cross-border application of the margin rules after taking into consideration comments on their prior proposal. Margin Requirements for Uncleared Swaps for Swap Dealers and Major Swap Participants-Cross-Border Application of the Margin Requirements, 80 Fed. Reg. 134 (proposed July 14, 2015) (to be codified at 17 C.F.R. pt. 23).
- <sup>7</sup> See Interpretative Guidance and Policy Statement Regarding Compliance with Certain Swap Regulations, 78 Fed. Reg. 144 (July 26, 2013).
- <sup>8</sup> For these purposes, it is a guarantee if a party to an uncleared swap has rights of recourse against a guarantor if the party has a conditional or unconditional legally enforceable right to receive or otherwise collect, in whole or in part, payments from the guarantor with respect to its counterparty’s obligations under the uncleared swap.
- <sup>9</sup> This includes US branches of non-US CSEs and FCSS.
- <sup>10</sup> The cross border rules allow the CFTC to consider the comparability of the form and amount of initial margin required and timing of posting.
- <sup>11</sup> The CFTC margin rules would apply, however, if the swap of the non-US CSE is not covered by a comparability determination and the non-US CSE enters into an inter-affiliate swap transferring the risk of the swap to a margin affiliate that is a US CSE or a CSE guaranteed by a US person.
- <sup>12</sup> The Final Margin Rules prescribe how a CSE can hold margin collected, including requiring certain margin to be segregated pursuant to a custodial agreement prohibiting rehypothecation of the margin held by the custodian.
- <sup>13</sup> The Prudential Regulators do not use the term FCS, but instead refer to non-US bank CSEs that are consolidated subsidiaries of a US parent.